STATE OF CALIFORNIA

DEPARTMENT OF INSURANCE

PROPOSED DECISION

RH—03028607

In the Matter of: Proposed adoption of the Insurance Commissioner's regulations pertaining to pure premium rates for workers' compensation insurance, to be effective on July 1, 2003.

A public hearing was held on the captioned matter at the time and place set forth in the Notice of Proposed Action and Notice of Public Hearing, File Number RH--03028607 dated April 2, 2003, which is included in the record. The record discloses the persons and entities to whom or which the Notice was disseminated. The Notice summarized the proposed changes and recited that a summary of the information submitted by the Insurance Commissioner in connection with the proposed changes was available to the public. In addition, the "Filing Letter" dated April 2, 2003 submitted by the Workers' Compensation Insurance Rating Bureau of California (WCIRB)and related documents were available for inspection by the public at the San Francisco and Los Angeles offices of the Department of Insurance and were also available for inspection on the WCIRB website at www.wcirbonline.org.

Testimony from the WCIRB and others, written and oral, was taken at a hearing in San Francisco on May 8, 2003 and exhibits were received into the record. The hearing panel included Insurance Commissioner John Garamendi and Senior Actuaries Ronald Dahlquist and Eric Johnson. Senior Staff Counsel Larry C. White was the hearing officer.

The matter was submitted for decision at the conclusion of the hearing, subject to the record remaining open for additional written comments received at the San Francisco office of the Department of Insurance by 5 P.M. on May 13, 2003. The matter having been duly heard and considered, the following Proposed Decision and Proposed Order are hereby made.

EXPLANATION AND HISTORY

The matters considered at the hearing consisted of proposed changes in the regulations of the Insurance Commissioner regarding workers' compensation pure premium rates. In addition, the WCIRB has proposed changes in the Uniform Statistical Reporting Plan—1995 and the California Workers' Compensation Experience Rating Plan—1995. The new regulations will apply to new and renewal policies with anniversary rating dates on or after July 1, 2003.

The changes in the regulations were proposed to the Insurance Commissioner in a letter with attachments (the "Filing Letter") dated April 2, 2003, submitted by the Workers' Compensation Insurance Rating Bureau of California, a licensed workers' compensation insurance rating organization.

The Bureau's filing proposed pure premium rates that reflect insurer loss costs and loss adjustment expenses.

The Bureau has proposed an increase in pure premium rates of 10.6% to be effective for new and renewal policies with anniversary rating dates on or after July 1, 2003. For reasons detailed below, the Department adopts an average increase of 7.2%.

THE ADOPTED PURE PREMIUM AND ITS DETERMINATION

Pure premium rates approved by the Insurance Commissioner reflect only loss costs, including loss adjustment expenses; they do not include any provision for general expenses, commissions, other acquisition expenses, premium taxes, or profits. These pure premium rates are not mandatory; they are advisory only.

Our decisions typically discuss two categories of items: changes in the Bureau's proposed methodology from prior filings and issues raised by other parties.

In this filing the WCIRB has continued to use the same basic methodology as in its last filing, even though our decision on that filing rejected two aspects of the methodology. Those two aspects are the use of a three-year trend period for loss development factors and the inclusion of a utilization impact on medical costs due to indemnity benefit increases. The WCIRB also has changed one aspect of its methodology from its last interim rate filing by including the most recent accident year in the loss development projection. In addition to these issues, actuary Allan Schwartz, on behalf of the California Applicants' Attorneys Association, submitted a report criticizing <u>four</u> factors of the filing.

We reject again the three-year trend period and the medical utilization factors. We allow the inclusion of the latest accident year. The result of these changes is to reduce the impact of the WCIRB's advisory pure premium rate filing from a filed increase of 10.6% to an approved increase of 7.2%.

While we value actuarial input from other parties, we find that Mr. Schwartz's comments on loss development and trend are rehashes of issues we have resolved in prior years and we find that his comments on allocated and unallocated loss adjustment expense are without merit.

<u>Use of Three-Year Trend Period for Loss Development Factors</u>

In our decision on the January 1, 2003 pure premium rate filing, we rejected the use of a three-year trend period for loss development factors. Instead we ordered the WCIRB to use a five-year trend period. We said that the proposed method crosses the line in the

actuarial trade-off between stability and responsiveness and that the use of just three points to fit a curve is inherently unreliable and unsound.

This is the WCIRB's first filing to use the three-point fit to such immature accident-year data. Applied to 12-month to ultimate development factors, we find the method even more unreliable than when applied to 18-ultimate factors.

In defense of the use of three years, the WCIRB repeats the argument that the retrospective test of accuracy favors it over the five year, and provides the retrospective test for three successive years.

We note that the tests applied to the latest possible time period, that is the factors predicted from the 12-31-2001 data and tested by development through 2002, shows a significant increase in overall accuracy when compared to the previous two time periods. While the three-point fit does appear to have been more accurate for medical, it is less clear cut for indemnity. In particular we note that for the most recent period, using the three-point fit resulted in a forecast that overshot the actual by 3.2%. This overestimation appears to be consistent across nearly all of the first six development stages, which were the only ones to which the development factors are trended.

On the whole for indemnity, the five-year trend produced a more accurate estimation (-1.4%) than did the three-year trend. For medical, the three-year trend also overestimated the development factors for the two latest stages of the six: the 60-72 months and 72-84 months' factors. The five-year trend actually produced more accurate estimates for these factors. Both the three-and five-year trends produced similar estimates for the 36-48 months and the 48-60 months' factors. It was only the first two factors: the 12-24 months and 24-36 months' factors: for which the three-year trend produced a more accurate estimate. If we assume the increased accuracy of the development factor trending methods represents a trend, we should expect that the five-year trending method will produce more accurate results than the three-year trending method in this current filing on an overall basis.

The WCIRB also points again to what it contends are leading indicators for loss development. These are the quarterly development factors, the claim disposal ratios and the paid to incurred ratios. In past decisions we have looked to these as a guide whether to trend the development factors at all rather than the latest observed development factor. It is not clear how these can be used to determine a preference for trending three years or five. For the claim disposal ratio, we note that for accident year 2002, the 12-month ratio is slightly higher than the previous year. This is only one point and is certainly not enough to suggest a turning point in the overall pattern of increasing development factor. However it is the most recent point for the age that contributes the most to the difference in forecasting errors. It suggests the possibility of at least a temporary reprieve in the need for ever more aggressively responsive loss development methods.

Utilization Impact on Medical Costs

In our decision on the January 1, 2003 pure premium rate filing, we rejected the application of the 0.26 utilization factor to medical costs. Despite that rejection, the WCIRB includes the factor in this filing. In a letter dated April 24, 2003, the WCIRB gives three reasons why. They say that: first, there is a significant correlation between indemnity benefit changes and changes in medical losses per $100 of payroll; second, that a UC Berkeley report confirms that a significant number of the new indemnity claims are entirely new claims to the system, rather than former medical-only claims; third, that many of the new indemnity claims would be cumulative injury claims which are very frequently litigated and the average cost of medical is about 25 times higher than that of a medical-only claim.

For the first argument, the WCIRB offered a regression analysis. The underlying medical loss data was from unit statistical reports for policy years 1969 through 1997. In its May 13 letter, the WCIRB says this is more appropriate than an accident year analysis because the denominator is not distorted by various premium changes. These are the same accident year loss ratios that are used in the WCIRB's calculation of their advisory pure premiums. We would observe that any distortions in the accident year data must be presumed to be minor, if the data is to be considered to be usable for pure premium ratemaking purposes. Accordingly, we are not inclined to dismiss the accident year analysis.

The policy year regression produces a relatively low correlation coefficient of .452. The more familiar "R-Squared" is .204 (that is, .452 times .452). This in itself is evidence at best of a weak correlation and does not justify the use of the utilization factor.

The accident year regression produces a higher R-Squared of .537. However, there is a curious difference of method between the policy year and accident year analysis that the WCIRB does not point out. While the policy year analysis compares the annual changes in the loss level, the accident year analysis compares the actual loss ratio. It is well known in the actuarial literature that for inflation-sensitive variables, it is preferable to fit the changes in the variable rather than the actual variable. Comparing the cumulative benefit index and the medical costs per payroll dollar merely shows that over three decades both have increased considerably, a result is not particularly surprising or illuminating. What the WCIRB needs to show is that both go up at the same time and in the same relative magnitude. Looking at the changes in the variables instead enables us to test this. Recalculating using the changes in the variables drops the accident year R-Squared down to 0.0063. No one would accept such a low R-Squared as evidence of a correlation.

The principal difference between the policy year and recalculated accident year analysis would appear to be the addition of the years 1998 to 2002, where small increases in benefits coincided with large increases in medical costs. Another difference may be that the policy year data, because they're based on unit statistical data, are not developed to full maturity. Given the lengthening development of medical payments, this may understate the growth in medical costs.

For the second argument, the WCIRB cites a draft of a report called "Indirect Effects and Benefit Changes: An Analysis of Temporary and Permanent Disability Benefit Changes and the Frequency and Duration of Benefit Receipt." A closer reading of the report does not appear to support the WCIRB's interpretation of it. Page 96 of the report says, "The WCRIB (sic) makes the assumptions that all claims are new to the system and have medical costs equal to the average for claims receiving the benefit type (TD and/or PPD." The report rejects both of these assumptions. Page 106 reads, "[W]hen frequency effects are found for benefit increases, approximately a quarter of the increase in indemnity claims is claims that, absent the benefit increase, would not have been reported, even as medical-only claims." (The report found a frequency effect for the 1994 benefit increase but not for the 1995 benefit increase.) The report continues, "In estimating the impact on medical costs, analyst should be careful to consider the preliminary evidence that indicates that these new indemnity claims are likely to have average medical costs that are lower than the average for all indemnity claims. A more appropriate estimate of medical costs on new claims might be mid-point between the average for medical-only claims and average for indemnity claims."

The WCIRB's May 13 letter says, "The UC study does not address the increase in medical costs on medical-only claims that become indemnity claims as a result of the higher benefits." Page 104 of the report says that the data is "consistent with the transition from medical-only claims to indemnity claims being cost neutral."

The WCIRB also notes that the report finds a severity effect for the indemnity portion of temporary claims and that the WCIRB has not factored this in. They argue that this understatement should be allowed as an offset to any possible overstatement on the medical utilization. We observe, however, that the severity effect was observed only for temporary claims, not permanent claims, and that temporary claims make up only about 5% of the total indemnity dollars. Therefore the understatement on indemnity severity appears to pale in significance to the overstatement on medical.

For the third argument, the WCIRB does not say how many of the new claims would be cumulative injury claims. The WCIRB adds that "In order to conclude that the AB 749 benefit increases do not increase medical cost, the new indemnity claims attributable to the AB 749 benefit increase would (a) have had to otherwise been medical-only claims if not for the benefit increases and (b) not have had their medical costs affected by the indemnity claim adjudication process." As we have already discussed, the UC Berkeley report finds that three-quarters of the new indemnity claims would indeed have been medical-only and that the effect on the medical costs is "cost neutral".

We note that the report found that the severity effect of a permanent disability benefit increase on permanent claims is negative. Such a result is surprising. Page 11 of the report says, "A probable interpretation is that the paid amounts are inelastic with respect to benefit levels because 1) they incorporate other considerations that are not affected by benefit levels or 2) system participants are slow to adjust customary settlement estimates for changes in benefit levels." On the second point, we note that the study was restricted

to a window of one year before to one year after a benefit change. It is quite possible that system participants do adjust after the one-year window closes. However, if this is not the case, it would appear that the overall frequency and severity utilization effect across all benefit types is negative, not positive.

While this issue does not have a major impact on the indicated pure premium rate level, we have several concerns that go beyond the effect of this issue on this filing. First, we are concerned about the precedent it sets. The impact will be cumulative throughout the multi-year period of implementation of AB 749, and it may be larger for benefit increases enacted in the future. Second, we note that the WCIRB uses the same approach and the same utilization factor to value changes in the law. It would be unfortunate if the policy debate over what is an appropriate and affordable indemnity benefit were distorted by inflated cost estimates. Third, we are concerned about what this issue may imply about other portions of the WCIRB's analysis. In the past, the WCIRB's cost estimates have been seen as objective and reliable. We are concerned that the WCIRB is not able to offer a better defense of this particular aspect of its methodology.

Use of the 2002 Accident Year in the Loss Development Projection

For last year's July 1 interim rate filing, the WCIRB used a loss projection method that did not include the latest available accident year data, 2001. Excluding the latest year raised their indicated rate change from 5.2% to 10.1%. In this year's interim filing, the WCIRB does include the latest year, 2002. Including the latest year raises the rate change from about 9% to 10.6%. We find that including the latest year is appropriate.

For the prior filing, the WCIRB listed three concerns with using the latest accident year. First, only about 10% of losses were paid at 12 months, and loss development factors in the range of 10 are inherently volatile. Second, 12-month projections for each of the last six years had significantly understated the ultimate loss ratios. Third, the projection using incurred loss development was 20 points higher than the projection using paid loss development.

We were not convinced by the argument that a projection based on 12-month data was considerably less reliable than one based on 24-month data, let alone the 15-month data the WCIRB always uses in its annual filings. (Typically the WCIRB is able to provide 18-month data before the hearing record closes.) However, we noted that all the other indicators except the accident year 2001 pure premium ratio implied worsening development. With an additional year of development, we can see that the previous estimate of the accident year 2001 loss ratio was badly understated.

The WCIRB now wants to include the latest year, for two reasons. First, the three-year trending of the development factors is more aggressive, and using the latest year produces a higher indication than not using it, so, they say, it is less likely that the ultimate loss ratio is understated. Second, they say, the leading indicators do not suggest that the ultimate loss ratio is overstated.

We are troubled by the lack of reliability and robustness for the 12-month development factors. For the last interim filing, the WCIRB shared this concern. The inherent volatility has not decreased since then.

As we did last year, we turn to the so-called leading indicators. One of them suggests the possibility that the accident year 2002 ultimate loss ratio is overstated: the ultimate claims disposal ratio has increased from 23.3% to 24.7%. Excluding accident year 2002 enables us to avoid this possible overstatement, but leaves us relying completely on the older accident years. For these older accident years, the disposal ratios tell a different story. Instead of increasing, they continue the pattern of many years and show decreases again this year. Relying on the older accident years exclusively runs a greater risk of underestimating the projected ultimate loss ratio.

Allan Schwartz Testimony

We have reviewed the written testimony of Mr. Allan Schwartz of AIS Risk Consultants, submitted on behalf of the Applicants' Attorneys Association. Mr. Schwartz presented an actuarial analysis that produced an indicated pure premium change of –2.4%, in contrast to the WCIRB's filed effect of +10.6%. The principal differences between Mr. Schwartz's analysis and that of the WCIRB were in the treatment of loss development, trend, and the provision for loss adjustment expense.

After having reviewed this analysis, we are of the overall opinion that Mr. Schwartz is not sufficiently familiar with the issues currently surrounding California workers compensation, or the difficulties that the WCIRB and most actuaries analyzing California workers compensation experience have had in accurately estimating future loss development. As a result, he has advocated the use of methodologies that the WCIRB and other practicing actuaries have already tried and have proven to be inadequate. These methodologies have significantly underestimated future loss development and thus ultimate loss costs. This in turn has led insurers to significant and serious underpricing and under-reserving, which have been major causes of insurer insolvencies and the collapse of our California workers compensation market.

We believe that Mr. Schwartz's indicated pure premium change of –2.4%, if adopted, would seriously underestimate loss costs for the prospective period the approved advisory pure premiums would be in effect. If insurers were to base their filed rates on advisory pure premiums approved at the level Mr. Schwartz recommends, we believe that our problems with under-reserving, poor financial results, and a lack of interest in the California workers compensation market would continue. This would also continue to put more pressure on the State Compensation Insurance Fund to hold the market together at a time when it is not on sound financial footing. It is even possible that more insurer insolvencies could result from this decision, thereby adding to the burden carried by the already overburdened California Insurance Guarantee Association.

Accordingly, we do not believe it would be prudent or responsible to approve advisory pure premiums at this level.

We have concluded that we differ with several of the judgements made in Mr. Schwartz's analysis, and thus arrive at a different conclusion. Our points of difference are explained as follows.

Loss Development:

Mr. Schwartz observes that the WCIRB's practice of trending loss development factors is unusual, and by implication, aggressive. After asserting that the WCIRB filing shows a cyclical pattern in the loss development factors, he further asserts that several changes to California law enacted as part of AB 749 can be expected to cause an end to the pattern of increasing loss development. He cites the elimination of the treating physician presumption as the most important such change, and refers to other provisions of AB 749 relating to control of prescription drug costs and the automatic qualification of licensed HMOs as qualified Health Care Organizations.

We agree that that the WCIRB's practice of trending loss development factors is unusual. We do not agree, however, that the practice of trending loss development factors is inherently wrong in situations such as the current one in California Workers Compensation.

There is ample evidence that the WCIRB's past estimates of ultimate loss, as presented in various filings over the last several years, have proven to be inadequate. This is especially true for medical losses. With very few exceptions, the age-to-age paid loss development factors observed in the data presented for each new filing have exceeded the factors predicted in the previous filing. The WCIRB has periodically revised its loss development methodology, adopting successively more unusual and aggressive approaches in the attempt to estimate future loss development accurately. To date, there is no evidence that they have been successful.

The general assumption underlying most actuarial reserving methods is that past patterns in historical data can be used to accurately predict future development, and thus ultimate cost. In the case of the paid loss development method, there is a major implicit assumption that historical patterns of paid loss development will continue in the future. Underlying this key assumption is a more general one- that all conditions that gave rise to the observed historical payment pattern will continue to remain the same as they were in the historical period. Unfortunately, in the instance of California workers compensation, and especially in the case of medical losses, this is clearly not the case. Clearly, the rate at which California workers compensation claims are closed is slowing down. This slowdown is significant, substantial, and has been going on for a long time. It affects the entire history of all accident years since the implementation of open rating in 1995. This slowdown in claim settlement would, by itself, be presumed to indicate a continuation of the slowdown in payment patterns we have been seeing.

Mr. Schwartz proposes that we disallow the use of trended loss development factors, and rely instead on the latest historically observed values. In light of the continued slowdown in the rate of claim closing, and in the absence of clear and convincing evidence that

conditions have changed or are very likely to change in the immediate future, we do not believe this is appropriate. We think that reliance on the latest observed age-to-age development factors would virtually guarantee that we would underestimate ultimate losses, perhaps seriously. This is exactly what has been happening for the last several years.

We agree with Mr. Schwartz that the upward trend in loss development factors will not continue indefinitely, and that it is likely to reverse itself at some point in the future. The difficulty is in predicting in advance when that will occur. We do not agree that his references to the newly effective provisions of AB 749 give us sufficient cause to expect the upward trend to stop in the current calendar year.

The new law states that the repeal of the treating physician presumption is effective for injuries occurring on or after January 1, 2003, so it will have no effect on the development of losses on claims from accident years 2002 and prior. Thus it will have no effect on the development of the data presented in the filing.

We think that the provision allowing currently licensed HMOs to automatically qualify as HCOs will have little, if any, effect on the development of losses arising from accident years 2002 and prior. We could not find anything in the new law that would limit the applicability of newly qualified HCOs to injuries occurring on or after January 1, 2003. We note, however, that the use of an HCO allows the employer to maintain control of medical treatment for an additional 90 days. We think it would be impractical to extend control to more than a small fraction of accident year 2002 claims, even if a majority of the insurers established relationships with HCOs immediately as of January 1, 2003. To our knowledge, this has not occurred.

Finally, we note that pharmaceutical costs are a relatively small percentage of the total medical costs under workers compensation. We do not believe the potential cost controls enacted with AB 749 will have enough of an effect by themselves to materially change overall medical loss development patterns.

For all of these reasons, we do not believe that the use of the latest observed age-to-age factors to estimate future development of medical losses for accident years 2002 and prior is either appropriate or prudent.

We have explained, both in this and the first previous decision, why we do not agree that the WCIRB's specific practice of basing the trend in loss development factors on a three-point fit is appropriate. As explained in a previous section of this decision, we have substituted trended loss development factors based on a five-point fit.

Trend

Mr. Schwartz 's analysis also differed significantly from the WCIRB methodology in the area of on-level pure premium ratio trend.

His analysis started with his own estimated ultimate on-level pure premium ratios, which were the result of his alternative loss development analysis. With this as the basis, he recomputed the trended pure premium ratios for both indemnity and medical using the WCIRB double exponential smoothing method. His method differed from the WCIRB's in that he used all of the accident years from 1990 through 2002 in the fitting process.

In addition to recalculating the double exponential smoothing, he also performed his own regression analysis, using exponential curves of best fit to the same recalculated on-level pure premium ratios. His curve fits include 11 different combinations of accident years: 1990-2002, 1991-2002, 1992-2002, and so on, finishing with 2000-2002.

His final selections were based on the following: for indemnity, he concluded that there was essentially no residual trend, so his selection of the projected on-level pure premium ratio under the new rates was the average of the on-level pure premium ratios for the four accident years 1999 through 2002; for medical, he first determined the average of the projected on-level pure premium ratios determined by exponential curves of best fit for all eleven combinations of accident years, and then averaged that result with the results of his double exponential smoothing calculation.

We have two main objections to this trend analysis. The first is that the trend analysis uses Mr. Schwartz's alternative estimates of on-level pure premium ratios that are derived using a loss development methodology we disagree with. We observe that his loss development methodology produces estimated on-level pure premium ratios that underestimate the appropriate level of losses for the most recent accident years. Further, the degree of underestimation becomes progressively larger with each accident year, with the latest accident year being underestimated to the largest degree. The result of using these underestimated pure premium ratios as the basis for the trend analysis is that the indicated trend rates will be understated. The fewer the years used in the exponential curve of best fit, the greater the underestimation will be. This phenomenon is clearly shown in the projections based on accident years 2000-2002, 1999-2002, and 1998-2002 for both indemnity (on Mr. Schwartz's Schedule AIS-2, Sheet 1) and medical (on his Schedule AIS-3, Sheet 1).

Our second objection is with the inclusion of accident years 1990-1992 in both the double exponential smoothing analyses and the exponential curves of best fit. It is clear by simple examination of the graphs presented as Exhibit 7, Sheets 1 and 2 of Section A in the WCIRB filing that the experience of this time period is an aberration, and that including it in any trend calculation will distort the estimated trend rate significantly. This is demonstrated by the results of Mr. Schwartz's exponential curve fitting analysis referenced in the previous paragraph. The trend rates and projected pure premium ratios for the curve fits including the data from any of the three accident years 1990, 1991, and 1992 are significantly lower than those that do not include these years. The r-squared values for the same curve fits are lower than the r-squared values for those that do not include accident years 1990, 1991, and 1992, indicating the curve fits are not as good.

It is our position that any trend calculation should be based on time periods that are free from major distortions in the data, in order to avoid distorted estimates of trend. Accordingly, since accident years 1990 through 1992 clearly represent a major distortion, they should be excluded from any trend calculation.

We also know enough about the causes of the rapid escalation and subsequent decline in costs in the period from 1990 through 1992 to know that the period was truly an aberration. The rapid escalation in costs was brought about at least in part by a dramatic increase in post-termination claims. The rapid decline in costs occurred due to a decrease in layoffs and the enactment of anti-fraud reforms and legislation designed to limit post-termination claims.

We do agree with Mr. Schwartz that the indemnity on-level pure premium ratios have flattened out in the most recent years. It is not clear to us that there is currently a positive residual trend in indemnity. However, we are at least somewhat concerned that what we are observing may be a temporary pause, and that the historical upward trend may resume in the near future. An examination of the graph presented as Exhibit 7, Sheet 1 of Section A in the WCIRB filing shows that such a temporary pause has occurred in the past, specifically for accident years 1975 through 1979.

At the same time, a visual examination of the graph presented as Exhibit 7, Sheet 2 of Section A in the WCIRB filing shows that the WCIRB may have underestimated the medical residual trend. It would appear that any potential overestimation of indemnity residual trend would be more than compensated for by the potential underestimation of medical residual trend.

We acknowledge that Mr. Schwartz's comments regarding the potential impact of AB 749's various cost controls are likely to have more impact on the trend calculation than we think they will have on the development analysis. We note, however, that the WCIRB has assumed a significant impact for these provisions in their evaluation of AB 749, as filed in the 1-1-2003 filing, and that the same impact is included in this filing. In this filing, it is found in column (5) of Section A, Exhibit 4, Sheet 3.

On par, subject to the qualifications we have noted, we consider the WCIRB's overall approach to the trend analysis to be reasonable. For the reasons stated above, we cannot make the same statement with regard to Mr. Schwartz's trend analysis.

Loss Adjustment Expense

Allocated Loss Adjustment Expense

The WCIRB uses the average of two methods to calculate its allocated loss adjustment expense (ALAE) projection: paid ALAE development and paid ALAE development as a percent of indemnity losses. Mr. Schwartz says the second method is not reliable.

We respectfully disagree with Mr. Schwartz. (We note that he mischaracterizes the first method as being based on premium. While premiums are used at a middle stage of the

calculation, they are factored out along the way and the final calculation is based on losses, that is, indemnity plus medical.) He gives four reasons why he believes the second method is less reliable. Only the fourth has any possible merit and even there it is dubious.

We find that the second method is more reliable, because we have more confidence in the WCIRB's projection of indemnity costs than we do in their projections of medical costs. This is not intended as a criticism of the WCIRB; it is a mere statement of the fact that it is in the medical costs, not the indemnity, where the development factors and the ultimate loss ratios have continued to spiral higher.

ALAE as a percentage of indemnity plus medical is flat or declining over the last few years. Mr. Schwartz finds a significance in this that we don't. We find it more significant that, as a percent of indemnity, ALAE has been going up consistently. ALAE is only appearing to flatten because the medical costs have been soaring. The bureau's calculation using just indemnity is 10.2% and their selection (based on the average of the two methods) is 9.8%, which seems reasonable.

Unallocated Loss Adjustment Expense

The WCIRB calculates the ratio of calendar year incurred unallocated loss adjustment expense (ULAE) to incurred losses and bases its projection on the average of the latest two years. Mr. Schwartz observes that there appears to be a downward trend since the mid-1990s, though rather than projecting the trend further downward, he uses the latest year.

The numbers are on a calendar year basis, so in addition to being distorted by the soaring medical losses, they are also possibly distorted by any catching up on past underreserving of losses. One sees a drop in the ALAE on a calendar year basis over the last few years from 9.9% to 4.1%, but one does not see a similar drop in the more reliable accident year data. The drop Mr. Schwartz sees in the calendar year ULAE data is probably a mirage too. Above, we found that 9.8% is a reasonable selection on an accident year basis for the ALAE. This is considerably higher than the numbers seen in the last two years on a calendar year basis. Similarly, it seems reasonable to attach little significance to the last few calendar years for ULAE. The bureau's selection of 8.7% for ULAE appears reasonable compared to the 9.1% seen in calendar year 1999.

OTHER MATTERS

The WCIRB has proposed a change to the Uniform Statistical Reporting Plan—1995 to clarify that premium charges arising from the federal Terrorism Risk Insurance Act of 2002 shall not be reported as in the "Total Standard Premium" field on the unit statistical report. In addition, the WCIRB has proposed that the California Experience Rating Plan—1995 be amended in two respects. The first is that premium charges arising from the federal Terrorism Risk Insurance Act of 2002 be excluded from the definitions of

premium. Secondly, the WCIRB has proposed that the eligibility threshold requirement for experience rating be raised to reflect the proposed raise in the pure premium rates.

These proposed changes are appropriate and are adopted, however the eligibility threshold requirement is changed to reflect the 7.2% increase in the pure premium rates that is approved in this Proposed Decision.

PROPOSED ORDER

WHEREFORE, IT IS ORDERED, by virtue of the authority vested in the Insurance Commissioner by California Insurance Code Sections 11734, 11750, 11750.3, 11751.5, and 11751.8 that Sections 2318.6 and 2353.1of Title 10 of the California Code of Regulations are hereby amended and modified in the respects specified herein.

IT IS FURTHER ORDERED that the experience rating threshold be calculated to reflect the pure premium rate increase adopted herein.

IT IS FURTHER ORDERED that these regulations shall be effective July 1, 2003 for all new and renewal policies with anniversary rating dates on or after that date.

IT IS FURTHER ORDERED that amended rating plans filed by insurers that contain only a change in multiplier to reflect the approved pure premium rate increase adopted herein shall be effective upon filing with the commissioner.

I HEREBY CERTIFY that the foregoing constitutes my Proposed Decision and Proposed Order in the above entitled matter as a result of the hearing held before me as a Senior Staff Counsel of the Department of Insurance on May 8, 2003, and I hereby recommend its adoption as the Decision and Order of the Insurance Commissioner of the State of California.

June 6, 2003

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Larry C. White
Hearing Officer and Senior Staff Counsel

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